The (non) Reform of the Georgian Pension system, 1991–2011: A Brief History and Update

THINK TANKS

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Regional Competence-Building for Think-Tanks in the South Caucasus and Central Asia

2012[2008]

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Abstract: This study reviews the factors that played a major role in the development of the old-age pension system in Georgia, 1991-2009 and identifies three main stages in this process. Fiscal constraints and international technical assistance were the main factors behind reform initiatives undertaken before 2003 and during the first attempts to change the system. Political factors and liberal economic ideology influenced the patterns of pension policy development in the period 2004–2008, while the negative economic outcomes surrounding the Russian-Georgian War and Global Financial Crisis, along with decreasing political legitimacy, are thought to be major obstacles for comprehensive pension reform at present. The main lesson drawn by this study concerning the post 2012–2013 election-cycle pension initiatives is that decisive steps should be taken based on hard evidence, rather than ideological conviction.

Keywords: *Georgia, pensions, reforms, transition, government*

[1] This report is a shortened and updated version of the study published in the Caucasian Review of International Affairs in 2009, volume 3, issue 4, pp. 371-386.

Introduction

As with almost every dimension of economic and social life, the public pension systems was challenged by the turmoil of the 1990s. After the first few years of transition, institutions of representative democracy emerged, a new legal infrastructure was installed, and the private sector began to develop; whereas the question of fundamentally reforming the existing set of welfare policies, including pension arrangements, attracted little attention (Kornai 1997). Although the problems facing Georgia were common to all transition economies, they were aggravated by the specific circumstances of the country. On the revenue side, shrinking contribution bases and poor administration of revenue-generating systems destabilized resources for pension expenditure. On the benefit side, demographic aging, a shrinking labor force, and growing informal employment led to a marked increase in the number of pensioners compared to the number of contributors. Old-age pensions became low, unfair, and insufficient to protect pensioners from falling into extreme poverty (Castello Branco 1998). The inability of the new socio-economic environment to provide a sustainable social security system was 'one of the reasons for the general mistrust of democratic and market reforms' (Tvalchrelidze 2003, p. 16).

After the 'Rose Revolution' of 2003, the Georgian government made an unequivocal choice to liberalize the economy with fundamental changes made to existing social policies. These tendencies inevitably affected the pension system in Georgia. However, it is unclear what exactly determined the development of the pension system and whether policy changes and unimplemented reforms can be explained by prevailing economic and fiscal problems, by political limitations on available reform choices, by a combination of these factors or by some other circumstances.[2] To reach any conclusions about the relative validity of these arguments surrounding Georgia's pension-system reforms, it essential to establish the nature of the development of the pension system from a specific starting point: the dissolution of the Soviet Union. This study also intends to reveal the problems the pension system has faced and to evaluate the feasibility of future reforms. Reform of the pension system is defined as the totality of changes made to institutions, procedures and resources in order to ensure a replacement income after the age of retirement. The following three attempts at initiating systemic changes to the old-age pension system can be identified: the first was made consecutively in 1998–99 and 2002–03, the second in 2004–08 when reforms continued in

[2] Throughout this research the terms 'reform' and 'development' will be used interchangeably.

two different directions, then the third in 2009-11 when political and economic crisis contributed to shape the nature of the pension system.

The first stage of development: the economics of pensions

The socio-economic collapse associated with the dissolution of the Soviet Union in Georgia was reinforced by civil war which led to a national macroeconomic crisis, destroying the pension system. In 1995, the government rejected the system of differentiated pensions and replaced it with flat payments. Pension benefits were determined by simple arithmetic: the number of those formally employed in the population was multiplied by the average salary and tax rate, with revenues then divided by the number of pensioners (Kodua 2004). In 1996, the parametric adjustments of the system resulted in the retirement age being increased by five years for men and women respectively, the cancellation of early retirement provisions and the introduction of the right to pension benefits only for those who had previously contributed to the system (Jandieri 2008). Problems with the pension system were further aggravated by a serious economic crisis at the end of the 1990s. The impact of fiscal constraints on the pension system was first recognized by officials at the Ministry of Labor and Social Security, who initiated an agenda on pension reform.

The legislative package that was developed in line with the Act on State Pensions involved the Acts on State Social Insurance and Medical Examination. Although the bills envisaged the differentiation of pensions according to contributions and the payment period, they did not imply any pension formula or other means to calculate differentiated pension benefits (Kodua 2004). Ultimately, the bill was not approved and in 1999 the government established a working group with a more ambitious initiative in which the influence of the World Bank's pension orthodoxy became apparent. According to this reform project, the three pillar pension model envisaged the establishment of a mandatory state pension fund, providing a minimum pension, a mandatory non-state pension insurance and voluntary private pension insurance. However, implementing reforms was problematic mainly because the government was still engaged in broader political and economic reform and the pension system itself was corrupt and poorly administrated, while social taxes were high and tax administration extremely inefficient (Gelashvili 2008).

A new, ambitious initiative on reforming the state's social assistance schemes was established in 2002–03. At the end of 2003, the ongoing pension arrears amounted to 14 percent of the budget, while the average pension equaled 19 percent of the minimum adult subsistence level.[3] The government was unable to fulfill its core budget parameters, mainly due to the fiscal authorities' ineffectiveness as well as deficiencies in the tax legislation. In 2003, expenditures constituted only 77 percent of the initial plan, leading to growing pension arrears. The precarious condition of the budget pushed the country towards a very real threat of default (NBG 2004). These constraints created a vicious circle, though in the light of a forthcoming parliamentary election, the government announced systemic pension reforms to establish a new multi-pillar and financially sustainable old-age pension system (Khechinashvili 2008). At the same time, the World Bank actively engaged in the process, trying to advocate its own vision of pension reform, helping the government to draft new bills and design tax incentives for voluntary pension accounts. The authorities believed that their initiative was a compromise model of pension reform; however, virtually no political parties lobbied for these amendments through formal or informal consultations. The stakeholders only agreed on the necessity of paying pension arrears and on the introduction of the three-pillar pension model in principle (OSGF 2002).

Nevertheless, pension reforms had become one of the mainstream policy issues for the government. In particular, a package of draft bills was drawn up by the State United Social Insurance Fund together with the MOLHSA and the World Bank. It included the bills on Mandatory Social Insurance, Mandatory Pension Insurance and on the Individual Registration and Individual Accounts for Mandatory Social Insurance System (Antadze 2007). Pensions were comprised of two components: a minimal base part, which would be guaranteed and available to everyone who satisfied retirement requirements, and an insurance part, the amount of which would be differentiated and dependent upon the insurance service length and the amount of individual payments made to the account (I-News 2003). However, this reform was canceled due to fundamental political changes occurring in late 2003, when a new government came to power. Initially, the introduction of the draft bills was postponed until the beginning of 2005, but later the proposal was completely rejected. The opponents of this reform initiative criticized its economic rationality. Their own financial projections showed that individuals would have to save for their entire working lives, but would receive extremely low replacement rates.

[3] This was GEL 14, which at that time was approximately 6.40 USD.

The second stage of development: the politics of pensions

From 2004, two dimensions of pension system development can be distinguished. The new government improved welfare for the elderly by improving the public pension system and developing a general means-tested social assistance program. It became possible to redeem salary and pension arrears from previous years (NBG 2005). The authorities also largely managed to eradicate corruption, identify database falsifications and dismantle special preferences among and within the different groups of pensioners. In December 2005, a new Act on State Pensions was adopted. All Georgian citizens were granted the right to receive old-age pension benefits any time after the age of sixty for women and sixty-five for men. On the revenue side, the old-age pension system was also affected by new changes to the tax code. With regard to social policies, a decision was made to abolish the personified social insurance contributions and introduce a common social tax at a rate of 20 percent of all salaries and wages (Megrelishvili 2008). After this consolidation, the system of keeping records on individual employees and their taxable incomes was abolished, which meant any future differentiation of pensions became technically unfeasible. From 2008, further major changes to the Tax Code were introduced. The social tax was annulled and individuals became responsible for the payment of income tax at a rate of 25 percent of their gross earnings (Government of Georgia 2008).

On the benefit side, from 2004 the minimum, flat-rate pension was initially increased by GEL 28 per month, and then by GEL 38 in 2006. After the social unrest in November 2007, the government increased pensions by GEL 55 (Baramidze 2008).[4] During the 2008 presidential campaign, the opposition coalition proposed designing an old-age social security system in which pensions would be calculated based on years of service and individual accomplishments (IATP 2008). Nonetheless, the existing government remained in office, with a consequential announcement that parametric pension reform would be a central element of its '50-day Program' (OSGF 2008). Since March 2008, minimum pensions have increased by GEL 70. The pension replacement rate, however, remained at a very low level, which further highlighted the inadequacy of the existing pension system (Badurashvili 2008). In 2009, the authorities planned to increase pensions by USD 100, which, for the first time in recent history would be more than the minimum average subsistence level. After effectively dealing with the main technical problems regarding public pensions, the government realized that the system still faced many obstacles.

[4] In November 2007, the government dispersed an opposition rally by force, resulting in 'snap' presidential and parliamentary elections.

Senior government officials believed that the PAYG scheme was not sustainable in a country which had a shrinking and aging population, a negative net migration, and high life expectancy rates (Bendukidze 2008). At the same time, high levels of poverty required 'increasing the efficiency and effectiveness of state measures' (Megrelishvili 2008, p. 204). Growing pension expenditure and anti-poverty social assistance had to be financed from the same revenue source – which meant that prioritizing one would come at the expense of the other. From 2004 to 2006, intensive work was directed at introducing a means-tested social assistance system, and in 2008 its database included 41 percent of Georgian households and 38 percent of the population. The idea was that the government, based on proxy means-tested mechanisms, had to spend tax-payers money on those unable to care for themselves by giving them cash and other in-kind benefits, such as subsidies on communal services, health care, and education scholarships (Bregvadze 2008). This program included about 240,000 of the poorest old-age pensioners, almost a third of all retirees. After the unrest of November 2007, a political decision was made that scarce resources had to be devoted to increase the general pension for the entire population, which in turn reduced resources for the effective implementation of the means-tested social assistance program (Megrelishvili 2008).

From 2004, the authorities started to consider a transition to private pension schemes in order to create an environment in which people would be able to independently secure a decent retirement. The government began to argue, however, that within the prevailing economic environment, consumption may be a more effective strategy than saving for retirement (Baramidze 2008). The final pension reform decisions were withheld and work was started on tax incentives to stimulate savings. In early 2008, the parliament approved the government's package of draft bills, which implied the gradual reduction of income tax and the introduction of tax relief on incomes stemming from various types of deposits. The authorities considered this decision a step toward pension reform because it made investments, including pension savings, more profitable (Baramidze 2008), although it did not imply any special treatment for retirement accounts. This decision was partially justified by the earlier experience of 2004 when the introduction of special tax incentives for private insurance failed to generate a boom in pension accounts, although licensing of voluntary pension funds substantially increased (USAID 2005).

To counterbalance the government's approach toward pension reform, an initiative was taken by parliament in 2006 to establish the Pension Task Force, which was facilitated by the EU delegation in Georgia.[5] After extensive public consultation, the Pension Task Force proposed the introduction of a contributory funded pension scheme, which current workers would have the option to join. Future pensions would have two components: a monthly pension for life, from the age of sixty-five, equivalent to a capital reserve built up in a contributor's personal pension account and; second, a transfer of the value of the proportion of the current state pension to the contributor's personal pension account. The pension account would be administered in an autonomous pension fund, the assets of which would be managed by private-sector investment managers (Callund 2007).

In spite of being the most elaborate and up-to-date pension reform plan, the executive government disregarded the proposal. Among others, the Ministry of Finance strongly opposed this initiative due to a projected reduction in revenue during the transition period. It was also argued that the statistical calculations employed in the model were not reliable (Jandieri 2008). This confrontation indicated that senior executive officials had not only a better understanding of the political economy of pensions but also had more leverage over the final decision-making process, which meant that the Pension Task Force reform initiative could hardly succeed, even if its approach had been completely credible (Baramidze 2008). After the government effectively blocked the proposed initiative, the Pension Task Force was forced to adjust its agenda to the government's line. The idea on partially mandatory pension insurance was dismissed and work continued only on the development of voluntary pension schemes. The new model intended to enhance and formalize private pension mechanisms and create incentives for people to save in these schemes (Gelashvili 2008).

The third stage of development: the pension crisis

The military confrontation with Russia in August 2008 and the intense effects of the global financial crisis had consequences for the pension system. The slowing of economic growth and shrinking employment as well as reduced budgetary revenues and access to domestic and foreign financing, substantially affected the country's fiscal health (Parliament of Georgia 2009). The crisis made it much more difficult to implement comprehensive pension reforms (Gelashvili 2008), but also worsened the environment for financing existing state pensions and, at least for several years, prevented accomplishing the promised increase in flat-rate pensions to USD 100 (Civil Georgia 2009). Out of the USD 250-million grant given to Georgia as part of the USD 1 billion aid package pledged by the United States after the

[5] The Task Force functioned within the framework of the Policy Advice on Pension Reform in Georgia project which was funded by the European Union.

August war, a substantial part was allocated to cover pensions. However, in 2009, the government only managed to increase the monthly flat-rate pension by GEL 5, starting from January, and by an additional GEL 5 starting from November of that year.

At the beginning of 2009, it also became clear that 'USD 100 pension package,' – a part of the 50-month project delayed by the war and the global economic crisis – would include state-funded health insurance and other retirement benefits, thus confirming that pensioners would not receive the pledged amount in cash (Civil Georgia 2009). By 2010, a small number of protests were organized by pensioners demanding the equalization of pensions with the country's minimum subsistence level, supported by several oppositional groups, such as Kartuli Dasi, the Labour Party, the Freedom Party and the Christian Democratic Party (Tarkhnishvili 2010).[6] Although pension policy is not part of the local self-government system in Georgia, Tbilisi City Hall sponsored a GEL 10 pension raise for those pensioners residing in the capital city during the local elections in 2010. Transparency International (2010) described this practice as discriminatory and noted that similar programs were implemented in 2006 and 2008 during presidential and parliamentary elections, but not in the two election-free years of 2007 and 2009 (Civil Georgia 2010). Indeed, the first draft budget of election-free 2011 again did not envisage any increase in pensions and was criticised by some opposition lawmakers. The official position of the government was that 2011 was the year of 'budgetary stabilization.'

However, in April 2011 the government announced an upward revision of revenue due to larger than expected economic growth. The Ministry of Labor, Health, and Social Affairs received most of the additional funding, out of which GEL 55.2 million was allocated to increase the minimum monthly pension to GEL 100 starting from September 2011 (Civil Georgia 2011). The initial draft budget for 2012, submitted by the government and presented to parliament in October, did not specify further increases in pensions for 2012. However, in November 2011, the Prime Minister unveiled a 'pensions package' plan to increase the minimum monthly pension from the existing GEL 100 to GEL 125, accompanied by GEL 15 health insurance policies for all pensioners – both starting from September 2012 when a parliamentary election is expected to be held. The government insisted that these measures came close to USD 100, which was the amount pledged during the presidential election in 2008. In spite of this impressive growth of pensions, 2003-2011, the real purchasing power of

[6] Generally, political parties lacked any solid financial and economic justification for their pension programs (Murgulia et al. 2010).

benefits remained at very low level (Jgerenaia 2012). It has also been argued by officials that further pension increases would require comprehensive reforms allocating responsibilities between state, taxpayers and pensioners.

As a result of increased foreign financial aid in 2008-09, some international agencies became stronger drivers behind pension reform as the donors obliged the Georgian government to engage more proactively in paradigmatic pension reforms. The reports drafted within this framework (ADB 2010; Falkingham and Vlachantoni 2010; Gadbury and Schou-Zibell 2011) made grim projections of the elderly dependency ratio, which would place a growing burden on the rest of society. The creation of a Pension Review Group was specifically included as a policy action in the 2010 ADB program loan to Georgia, targeting the delivery of social services in the country with the intention of taking concrete steps, such as discussing, developing, and recommending pension policy change (ADB 2010). Under this program, the Ministry of Labor, Health, and Social Affairs engaged in a policy dialogue on various central domains, such as the long-term implications of the existing pension system for the state budget and the capacity of the financial sector to manage private pension funds. In March 2010, the Pension Review Group made amendments to the Law on Non-State Pension Insurance and Provision, which enabled private pension funds to diversify their investment options and promote information disclosure on investment directions and the ways through which pension returns are accumulated (ADB 2011).

Possibly more consequential work was conducted by the United States Agency for International Development through its Insurance and Pension Assessment initiative in Georgia. One of the main conclusions of this initiative was the need to consider some form of compulsory pension mechanism that could promote national savings because the experience with private pension funds was disappointing (Balbin 2011). The report revealed that both the Georgian government and business in general were supportive of a mandatory savings pension idea.[7] An increasing number of experts were also enthusiastic about comprehensive pension reforms (CIPDD 2011). Furthermore, USAID was asked by the Georgian government to prepare a concept paper on the proposal for mandatory pensions for further discussion among top government officials. The prepared concept note suggested that the current demographic dependency ratio made it the right time to consider initiating funded pensions. The simulations that were presented, showing a contribution rate to mandatory retirement

[7] In other words, in the World Bank Pillar II pension model a participant accrues savings to capitalize the purchase of an annuity that will provide him/her an income stream during retirement.

savings per participant of 7.5% of salary/wages, indicated that by the end of the fifth year, fund accumulation and pension asset growth in a privately operated mandatory savings pension model was robust and could reach GEL 3.5 Billion (EPI 2011).

By the beginning of 2011, and echoing these developments, the Ministry of Finance drafted a new reform proposal. From one perspective, this proposal was designed to fulfill the presidential pledge to increase pensions to 100 USD by 2013, with some differentiated benefits for several categories, such as the disabled and war veterans. From another perspective, a special pension fund would be created to mobilize resources through a 10% mandatory contribution rate from the population in formal employment, both employers and employees paying 5% of their salaries and wages. The initiative also envisioned increasing the retirement age for women to 65 from 2014, but most fundamentally it implied a discontinuation of accepting new members by 2015. This decision was expected to be extremely unpopular, as acknowledged by the document (Kvanchilashvili 2011Kvanchilashvili 2011). Nevertheless, the libertarian group, still having strong influence over governmental decisions, was arguably responsible for preventing the further evolution of this initiative, as the Finance Minister responsible for the project was dismissed a few months after the announcement of the project. The libertarians supported the idea of dismantling the public pension system, but opposed the introduction of mandatory pension savings. In fact, it was argued that if pensions remain at the same relative level in the state budget, the health of Georgian public finances would be unaffected, with no forthcoming increase in social liabilities (Megrelishvili, 2011 cited by Mchedlidze 2011).

Lessons learnt

This study outlined three consecutive attempts at amending the pension system in Georgia. Initially, the bottom-up reform initiative stemming from the Ministry of Labor and Social Security was blocked by the political indifference of the upper echelons of executive power; and when the fiscal problems intensified, the government became interested in gaining political dividends through the top-down reform initiative mediated by the World Bank. After 2004, the government was unable to exploit the post-election 'honeymoon', of high political legitimacy and a sound fiscal standing, to conduct systemic pension reform. The state's priority deviated from the universal pension system to the development of a universal means-tested social assistance program and presented the general tax reduction trend as a component of broader pension reforms, successfully blocking parliamentary attempts to introduce mandatory pension savings. After the dual 2008 crisis, the government still preferred to regularly increase the flat-rate pension as a way to win the votes of pensioners – the largest and most politically active demographic group – contributing to the transformation of pension expectations into pension liabilities, which not only assumed the sustainable provision of benefits but also their ever-increasing nature.

There are some lessons which can be drawn from this review of these pension initiatives. First of all, many key agencies did not have full information on up-to-date pension developments in the country. In addition to having a comprehensive debate on pension policy through sound research practices and consultation, it is more important is to have honest communication with the broader public on the objective requirements of the pension system. The reform process itself should be developed by a genuine cross-section of public officials, business leaders, trade union representatives and other interested parties – a practice which never happened in the period 1991-2011. It is also important to see pensions in a positive light, as an opportunity rather than a cost, or a problem. Last, but not least, it appears that most of the parties – pubic officials, international agencies, private sector – agree that changes are required. The major thing missing is a willingness to invest political capital into comprehensive pension reform. The parliamentary and presidential elections in 2012-2013 will presumably mark a formal transfer of power to a new government and will most likely weaken the positions of those who have resisted comprehensive pension reform, mainly based on their ideological convictions rather than on hard evidence. A more balanced distribution of political power may open new opportunities for sustainable, paradigmatic old-age pension reforms.

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